BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
FRED L. AND BLANCHE M. WATERS)

Appearances:

For Appellants: Archibald M. Mull, Jr., Attorney at Law

For Respondent: Wilbur F. Lavelle, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax against Fred L. Waters in the amount of $767.44 for the year 1951, against Blanche M. Waters in the amount of $767.44 for the year 1951, and against Fred L. and Blanche M. Waters in the amount of $1,807.24 for the year 1952.

Appellant Fred L. Waters (hereafter referred to as Appellant) conducted a coin machine business in Oakland under the name of Coin Play Amusement Company. Appellant owned about 25 bingo pinball machines, 10 flipper pinball machines and five shuffle alleys. The equipment was placed in approximately 17 locations, such as bars and restaurants. On July 9, 1952, Appellant executed a bill of sale of transfer title to the equipment, the good will and the business name to California Contract Company.

In addition, during 1551 Appellant and a partner owned Bart's Smoke Shop in Lmeryville. Appellant was the sole owner of that business throughout 1952. The Smoke Shop sold tobacco products, liquor, candy and other similar items. During the years 1951 and 1952 the Smoke Shop had on the premises four bingo pinball machines and two flipper pinball machines, all of which were owned by Appellant until July 9, 1952. Thereafter, they were owned by California Contract Company.

The proceeds from each machine in a location, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided, usually equally, between Appellant and the particular location owner. On the books of Coin Play Amusement Company, Bart's Smoke Shop was treated the same as any other location.

With respect to the Coin Play Amusement Company, the gross income reported by Appellant in tax returns was the total of amounts retained from locations. Deductions were taken for depreciation, salaries and other business expenses. Respondent determined that Appellant was renting space in the locations where his machines were placed and that all the coins deposited in the machines constituted gross income to him. Respondent also disallowed all expenses relating to the coin machine route pursuant to Section 17359 (now 17297) of the Revenue and Taxation Code which read:

> In computing net income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities.

The evidence indicates that the operating arrangements between Appellant and each location owner, with the exception of the Smoke Shop, were the same as those considered by us in Appeal of C. B. Hall, Sr., Cal. St. Bd. of Equal., Dec. 29, 1958, 2 CCH Cal. Tax Cas. Par. 201-197, 3 P-H State & Local Tax Serv. Cal. Par. 58145. Our conclusion in Hall that the machine owner and each location owner were engaged in a joint venture in the operation of these machines is, accordingly, applicable here. Thus, with the exception of the Smoke Shop, only one-half of the amounts deposited in the machines operated under the arrangements was includible in Appellant's gross income.

From May 3, 1951, the effective date of Section 17359, until the end of 1951 Appellant was entitled to one-half the amounts deposited in the six machines located at the Smoke Shop as the machine owner and to one-fourth of such amounts as a copartner in that location and therefore three-fourths of these amounts were includible in his gross income, During 1952 Appellant was the sole owner of Bart's Smoke Shop and thus the entire income from the machines located there was his until he sold the equipment and business of Coin Play Amusement Company on July 9, 1952. Thereafter, as a location owner, one-half of the amounts deposited in the six machines located at the Smoke Shop were includible in his gross income.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, CCH Cal. Tax Rep. Par. 201-984, 2 P-H State & Local Tax Serv. Cal. Par. 13288, we held the ownership or possession of a pinball machine to be illegal under Penal Code

Sections 330b, 330.1 and 330.5 if the machine was predominantly a game of chance or if cash was paid to players for unplayed free games, and we also held bingo pinball machines to be predominantly games of chance.

Based on the testimony of Appellant we conclude that it was the general practice to pay cash to players of Appellant's bingo pinball machines for free games not played off. Accordingly, the bingo pinball phase of Coin Play Amusement Company was illegal, both on the ground of ownership and possession of bingo pinball machines, which were predominantly games of chance, and on the ground that cash was paid to winning players. Respondent was therefore correct in applying Section 17359.

An employee of Appellant collected from and repaired all types of machines. Most of the locations had bingo pinball machines. There was therefore a substantial connection between the illegal operation of bingo pinball machines and the legal operation of the flipper pinball machines and shuffle alleys and Respondent was correct in disallowing all the expenses of Coin Play Amusement Company.

There were no records of amounts paid to winning players of the bingo pinball machines, and Respondent computed these unrecorded amounts as equal to 38.168 percent of the coins deposited in all types of machines. This percentage was derived from a test check of collection slips for November and December of 1952. Respondent's auditor testified that Appellant had told him during an interview in June 1955 that the collection slips used for the test were indicative of the operation during the years 1951 and 1952, and that the percentage arrived at appeared fair and reasonable. At the hearing in this matter, Appellant estimated that the payouts on pinball machines located at the Smoke Shop constituted about 30 or 35 percent, and he stated that he thought this would also be a fair estimate with respect to other locations. The 38.168 percent payout figure used by Respondent appears reasonable under the circumstances and is sustained.

In order to compute the amount of unrecorded payouts to be included in Appellant's gross income from the six pinball machines located at the Smoke Shop it is necessary to estimate the total amounts retained by him from those machines. Appellant had about 40 machines out on location and as machine owner retained therefrom $15,063.25 during the period from May 3, 1951, to December 31, 1951, and $17,024 during the period from January 1, 1952, to July 9, 1952. On the basis of the average income for each of the 40 machines, we conclude that from the proceeds of the machines in the Smoke Shop Appellant retained $2,259.48 as machine owner and $1,129.74 as a copartner in the partnership operating the Smoke Shop during the period from

May 3, 1951, to December 31, 1951, $2,553.60 as machine owner and $2,553.60 as the sole owner of the Smoke Shop during the period from January 1, 1952, to July 9, 1952, and $2,500 as the owner of the Smoke Shop for the balance of 1952.

Respondent did not adjust the income reported with respect to the Smoke Shop, but restricted its adjustments to the income reported by Appellant relative to the operation of Coin Play Amusement Company. At the end of the hearing, Respondent's counsel stated that if this Board should decide that a joint venture existed between each location owner and Coin Play Amusement Company then all of the expenses of the Smoke Shop should be disallowed under Section 17359. There is, however, insufficient evidence in the record to permit us to make any further adjustment based on the disallowance of expenses.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJULGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests to proposed assessments of additional personal income tax against Fred L. Waters in the amount of $767.44 for the year 1951, against Blanche M. Waters in the amount of $767.44 for the year 1951, and against Fred L. and Blanche M. Waters in the amount of $1,807.24 for the year 1952, be modified in that the gross income is to be recomputed in accordance with the opinion of the Board. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 11th day of July, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Richard Nevins, Member

_____, Member

_____, Member

ATTEST: H. F. Freeman, Secretary